Mid-Term Review of Annual Policy Statement for the year 2005-06

Reserve Bank of India
Mumbai

Statement by Dr. Y. Venugopal Reddy, Governor, Reserve Bank of India on the Mid-term Review of Annual Policy for the year 2005-06

This Statement consists of two parts: Part I. Review of Annual Statement on Monetary Policy for the Year 2005-06; and Part II. Review of Annual Statement on Developmental and Regulatory Policies for the Year 2005-06. An analytical review of macroeconomic and monetary developments was issued, a day in advance as a supplement to Part I of the Statement, providing the necessary information and technical analysis with the help of simple charts and tables.

Part I. Mid-term Review of Annual Statement on Monetary Policy for the Year 2005-06

2. This part is divided into three sections: I. Assessment of Macroeconomic and Monetary Developments during the First Half of 2005-06; II. Stance of Monetary Policy for the Second Half of 2005-06; and III. Monetary Measures.

I. Assessment of Macroeconomic and Monetary Developments during the First Half of 2005-06

Domestic Developments

3. The onset of the South-West monsoon was delayed this year by a week, but it picked up by end-June. As per the India Meteorological Department (IMD), excess or normal rainfall was observed in 32 of the 36 meteorological subdivisions and, for the country as a whole, rainfall during June-September this year was 99 per cent of its long period average. By current assessment of area coverage under various crops, it is likely that the *kharif* output may register an increase over the previous year's level. In addition, the improvement in water storage levels over the previous year augurs well for the outlook on *rabi* production.

4. Prospects for sustained growth in industrial output have improved in an environment of rising investment and export demand, strong corporate profitability and buoyant business confidence. The index of industrial production (IIP) increased by 8.8 per cent during April-August 2005 as compared with the increase of 8.0 per cent in the corresponding period of the previous year. There

are signs of sustained growth in the production of basic goods, capital goods and consumer goods. Despite some deceleration, export growth at 20.5 per cent in US dollar terms during April-September, 2005 has remained robust, as against 30.8 per cent in the corresponding period of the previous year.

5. In consonance with the sustained growth of industry, there is a surge in non-food credit growth. Exports of manufactured goods and services remain buoyant and the international business environment and investor confidence in India continue to remain positive. Domestic production and imports of capital goods have risen strongly in tandem, indicative of ongoing capacity expansion. With continued business expansion and lower interest costs, corporate profitability is high and there is an expansion in internal resources available for investment. These factors have found reflection in upbeat sentiments and a brightened investment climate. The assessment of the corporate sector as reflected in the Reserve Bank's Industrial Outlook Survey presents an optimistic picture and the expectations regarding the overall business situation for the October-December 2005 quarter have improved further. The performance indicators for output, exports, working capital finance requirements and capacity utilisation are expected to be well above their levels a year ago. Other business expectation surveys also exhibited similar improvements in outlook.

6. According to the Central Statistical Organisation (CSO), real GDP increased by 8.1 per cent during the first quarter of 2005-06 as against 7.6 per cent in the first quarter of the previous year. The elevated level of international crude prices imparts downside risks to overall GDP growth. At the same time, the robust industrial and service sector growth and buoyant exports are likely to have some positive impact on growth.

7. Scheduled commercial banks' credit increased by 14.2 per cent (Rs.1,55,712 crore) up to September 30, 2005 which was higher than the increase of 11.7 per cent (Rs.98,210 crore) in the corresponding period of last year. Food credit declined by Rs.1,571 crore – as against an increase of Rs.2,677 crore in the previous year – reflecting lower procurement of foodgrains during the current financial year. On the other hand, non-food credit posted an increase of 14.8 per cent (Rs.1,57,284 crore) as compared with an increase of 11.9 per cent (Rs.95,533 crore) in the corresponding period of the previous year. While the outstanding credit-deposit ratio increased to 65.8 per cent from 58.4 per cent a year ago, the incremental

non-food credit-deposit ratio declined to 75.2 per cent as compared with 92.9 per cent.

8. On a year-on-year basis, non-food credit growth at 31.5 per cent, net of conversion, as on September 30, 2005 was higher as compared with 24.9 per cent a year ago. Non-food credit has witnessed a structural shift towards the non-agriculture non-industrial sectors in recent years. Credit off-take during the current financial year (up to August 2005) has, however, been broad-based. Credit to industry increased by 21 per cent whereas credit off-take by agriculture and non-agriculture non-industrial sectors increased by over 35 per cent each. The growth in credit to non-agriculture non-industrial sector is led by housing, real estate and personal loans. Within the industrial sector, significant increase in credit off-take has been recorded by petroleum, coal products, power, roads and ports, cotton textiles, drugs and pharmaceuticals, gems and jewellery, iron and steel, other metal and metal products, automobiles and engineering.

9. Scheduled commercial banks' investments in bonds/debentures/shares of public sector undertakings and private corporate sector, commercial paper (CP), etc., declined by 11.7 per cent (Rs.11,043 crore) during the current year so far (up to September 30, 2005) as compared with a decline of 3.9 per cent (Rs.3,463 crore) in the corresponding period last year. Scheduled commercial banks' investments in instruments issued by financial institutions (FIs) and mutual funds also declined by Rs.3,835 crore as against a decline of Rs.2,864 crore in the previous year. With the significant expansion in non-food credit demand, the total flow of resources from scheduled commercial banks to the commercial sector increased by 12.7 per cent (Rs.1,46,241 crore) as compared with the increase of 10.3 per cent (Rs.92,070 crore) in the corresponding period of the previous year. The year-on-year growth in resource flow was also higher at 27.8 per cent, net of conversion, as against 21.4 per cent a year ago.

10. Money supply (M_3) increased by 9.6 per cent (Rs.2,15,394 crore) in the current financial year up to September 30, 2005 as compared with 5.4 per cent (Rs.1,08,791 crore) in the corresponding period of the previous year. On an annual basis, growth in M_3 at 16.6 per cent, net of conversion, was higher than 14.6 per cent in the previous year. Aggregate deposits of scheduled commercial banks rose by 12.3 per cent (Rs.2,09,015 crore) as compared with an increase of 6.8 per cent (Rs.1,02,885 crore) in the corresponding period of the previous year. On an annual basis, the growth in aggregate deposits at 18.6 per cent, net of conversion, was higher than that of 15.8 per cent a year ago.

11. Reserve money increased by 5.8 per cent (Rs.28,557 crore) in the current financial year up to October 14, 2005 as compared with the increase of 0.6 per cent (Rs.2,660 crore) in the corresponding period of the previous year. While currency in circulation increased by 6.1 per cent (Rs.22,516 crore) as compared with 4.3 per cent (Rs.14,039 crore), bankers' deposits with RBI increased by 6.5 per cent (Rs.7,431 crore) as against a decline of 12.4 per cent (Rs.12,930 crore). As regards the sources of reserve money, net RBI credit to the Central Government increased by Rs.11,897 crore as against a decline of Rs.21,395 crore. Adjusted for transactions under the liquidity adjustment facility (LAF), net RBI credit to the Central Government showed a lower increase of Rs.1,822 crore. The Reserve Bank's net foreign exchange assets (NFEA) increased by Rs.24,272 crore as against a higher increase of Rs.58,342 crore during the corresponding period of the previous year. NFEA adjusted for revaluation, however, increased by Rs.30,585 crore as compared with an increase of Rs.31,737 crore during the corresponding period of the previous year. The RBI's credit to banks and the commercial sector continued to decline because of reduced reliance on the standing facilities on account of comfortable liquidity conditions. The year-on-year increase in reserve money was 17.9 per cent as on October 14, 2005 as compared with 18.0 per cent a year ago. The balances under the market stabilisation scheme (MSS) which were Rs.64,211 crore as on March 31, 2005 increased to Rs.68,276 crore by October 14, 2005. The ratio of NFEA to currency declined marginally from 166.2 per cent in March to 162.9 per cent
(145.4 per cent, adjusted for MSS) by October 14, 2005.

12. Inflation, as measured by variations in the wholesale price index (WPI), on a point-to-point basis, receded from 6.0 per cent in April 2005 to 4.6 per cent by October 8, 2005 despite upward adjustments in the administered prices of petrol, diesel and electricity and increase in the prices of aviation turbine fuel, naphtha, furnace oil and iron and steel. On an average basis, annual inflation based on the WPI was 5.3 per cent as on October 8, 2005 as compared with 6.2 per cent a year ago.

13. At a disaggregated level, the prices of primary articles (weight: 22.0 per cent in the WPI basket) increased by 2.5 per cent as compared with an increase of 3.8 per cent in the previous year. The fall in prices of primary articles was mainly under non-food articles – raw cotton, oilseeds and sugarcane – and minerals, particularly iron ore. Prices of manufactured products (weight: 63.7 per

cent) increased by 2.6 per cent as compared with 7.2 per cent a year ago. In the category of manufactured products, declines in the prices of edible oils, oil cakes, cotton textiles and manmade fibres softened the effects of sharp increases in the prices of basic metals, alloys and metal products (particularly, iron and steel), chemicals and chemical products and machinery and machine tools.

14. The annual increase in prices of the 'fuel, power, light and lubricants' group (weight: 14.2 per cent) at 12.0 per cent (as on October 8, 2005) was higher than 10.7 per cent a year ago. Excluding the fuel group, however, inflation on an annual basis at 2.1 per cent was significantly lower than headline inflation. During 2005-06 so far, oil prices in the international markets have continued to remain high and volatile with the latest spike occurring at the end of August on account of Hurricane Katrina in the US. The average price of a basket of major international crude varieties (Brent, WTI and Dubai Fateh) at around US $60 per barrel during July-October 2005 was 18.4 per cent higher than in April-June 2005 and 42.6 per cent higher than its level a year ago. Domestic prices of petrol and diesel were revised upwards in June and again in September 2005. With the latest hike in prices effective September 6, 2005 the average domestic price of petrol and diesel (in the four metropolitan cities) has increased by 13.6 per cent over the end-March 2005 level and 22.0 per cent over the level a year ago.

15. The full effects of the pass-through of the increase in international oil prices have so far been dulled and the underlying inflationary pressures have been contained. Crude prices continue to remain the most critical factor in the outlook on domestic inflation. In the remaining part of the year, inflation conditions will warrant continuous vigil in view of the heightened uncertainties surrounding international crude prices and the eventual pressures for fuller pass-through into domestic inflation.

16. Inflation, as measured by variations in the consumer price index (CPI) for industrial workers on a point-to-point basis, was 3.5 per cent in August 2005 as against 4.6 per cent a year ago. On an annual average basis, inflation as reflected in the CPI, was 4.1 per cent in August 2005 as against 3.4 per cent a year ago.

17. The market borrowing programme of the Central Government has so far remained consistent with the projections set out in the Union Budget for 2005-06 which placed the net and gross market borrowings of the Central Government at Rs.1,10,291 crore and Rs.1,78,467 crore, respectively. By October 21, 2005 the

Central Government had completed net market borrowings of Rs.59,831 crore (54.3 per cent of the budgeted amount) and gross market borrowings of Rs.1,08,506 crore (60.8 per cent of the budgeted amount). The Central Government's borrowing programme broadly proceeded in alignment with the indicative issuance calendar for dated securities for the first half of 2005-06 which set gross borrowings through issuance of dated securities at Rs.83,000 crore. All issuances of dated securities were by way of fixed coupons in response to the favourable market appetite for such securities. During the second half, however, out of the two auctions scheduled in the indicative calendar of dated securities on October 6, 2005 all bids received in respect of one auction were rejected. On a review of the borrowing requirements, the auction of dated securities scheduled for October 18-25, 2005 for an amount of Rs.4,000 crore was cancelled in consultation with the Central Government. The weighted average yield on fresh borrowings through dated securities increased to 7.29 per cent (up to October 21), up from 5.76 per cent in the corresponding period last year. The weighted average maturity of dated securities of the Central Government increased to 15.1 years from 14.3 years over the same period. All issuances during the current financial year, except one, were reissuances reflecting efforts towards consolidation of public debt and imparting liquidity to the Government securities market. As against the provisional net allocation of Rs.16,112 crore (gross Rs.22,431 crore) for their market borrowing programme, the State Governments have raised Rs.6,274 crore (net) and Rs.14,265 crore (gross) up to October 21, 2005.

18. During 2005-06 so far (up to October 14, 2005), additional liquidity of Rs.4,065 crore was absorbed under the MSS. Notwithstanding the MSS operations, surplus liquidity conditions resulted in the reverse repo volumes tendered under the LAF increasing from an average of Rs.29,809 crore in March to Rs.34,832 crore in August before declining to Rs.21,128 crore in October 2005. Up to July, the absorption of liquidity through the MSS was more than offset by decreasing reverse repo levels. Thereafter, LAF reverse repo increased sharply as liquidity conditions eased with the resumption of inflows from abroad. Large MSS redemption in September resulted in accretions under LAF and absorption through acceptance of higher bids under fresh auctions. In addition to the MSS and the LAF, surplus balances in the Central Government account with the Reserve Bank rose from an average of Rs.5,142 crore in April-October 2004 to Rs.18,643 crore in April-October 2005 and also helped in sterilising excess

liquidity from time to time. Accordingly, the total liquidity that remained sterilised (in the form of MSS, LAF and surplus balances of Central Government) increased from an average of about Rs.1,14,192 crore in March to Rs.1,23,844 crore in August before declining to Rs.1,20,076 crore in October 2005.

19. The revenue deficit and gross fiscal deficit (GFD) of the Central Government at Rs.74,372 crore and Rs.86,328 crore, respectively, during April-August, 2005 accounted for about 78.0 per cent and 57.1 per cent of the budget estimates for 2005-06 as compared with 82.6 per cent and 38.2 per cent, respectively, in the corresponding period of 2004-05. During April-August 2005, the revenue deficit of the Centre was higher by 18.2 per cent than its level in the corresponding period of the previous year while the GFD was higher by 64.4 per cent. Adjusted for transactions under the discontinued debt swap scheme, the GFD was higher by only 8.1 per cent than its level a year ago.

20. The market borrowing programme of the Centre and the States envisaged for 2005-06 is higher than in the previous year. Superimposed upon the underlying liquidity conditions and shifts in banks' portfolio preferences in favour of credit as compared with investments, this has entailed some hardening of yields. Continued large borrowings from the market by the Centre and the States pose concerns for the efficient conduct of debt management as well as for monetary operations. In this context, the renewed commitment to fiscal consolidation through reduction in the revenue deficit and the gross fiscal deficit at all levels of Government and the diffusion of fiscal responsibility legislation at the sub-national level is heartening. States' budgets for 2005-06 have generally not taken into account the recommendations of the Twelfth Finance Commission (TFC) relating to devolution, transfers and debt relief. With the phasing out of Central Plan Loans to the States as recommended by the TFC, the market borrowings of the States is not likely to be out of alignment with the net allocation for 2005-06 in the light of higher devolution of taxes and grants from the Centre to the States and larger receipts from the national small saving fund (NSSF).

21. Scheduled commercial banks' investment in government and other approved securities at Rs.14,283 crore during the current year so far (up to September 30, 2005) was lower than that of Rs.28,526 crore in the corresponding period of the previous year, partly on account of the pick-up in credit demand. There has been substantial support for the market borrowing

programme from non-bank entities. Commercial banks' excess holding of SLR securities stood at Rs.2,24,701 crore.

22. Financial markets have remained stable and orderly although interest rates have firmed up in almost all segments. The average call money rate increased from 4.77 per cent in April to 5.06 per cent in October 2005 (up to October 21) although it has generally remained closely aligned with the LAF reverse repo rate. The 91-day and the 364-day Treasury Bill rates also increased from 5.12 per cent and 5.60 per cent in April to 5.53 per cent and 5.85 per cent, respectively, by October 2005. The 182-day Treasury Bill rate has moved up from 5.21 per cent to 5.78 per cent during this period. The yield on government securities with 1-year residual maturity in the secondary market increased from 5.66 per cent to 5.88 per cent. The yield on government securities with 10-year and 20-year residual maturities increased from 6.68 per cent and 7.08 per cent to 7.18 per cent and 7.52 per cent, respectively. With a relatively higher increase in the long-term yields, there was a steepening of the yield curve. The yield spread between 10-year and 1-year government securities moved up from 102 basis points to 130 basis points whereas the spread between 20-year and 1-year government securities increased from 142 basis points to 164 basis points.

23. The weighted average discount rate on commercial paper (CP) of 61 to 90-days maturity increased from 5.80 per cent in April to 5.89 per cent by mid-October 2005. The market repo rate increased from 4.63 per cent to 4.85 per cent with an increase in daily volume from Rs.3,958 crore (one leg) to Rs.5,661 crore by September 2005. The average daily volume of CBLO (collateralised borrowing and lending obligation) increased significantly from Rs.5,185 crore to Rs.8,572 crore along with an increase in the CBLO rate from 4.58 per cent to 4.80 per cent. The typical interest rate on 3-month certificates of deposit (CDs) increased from 5.87 per cent in April to 5.90 per cent by mid-September 2005. Public sector banks kept their rates for deposits of over one year maturity unchanged in the range of 5.25-6.50 per cent during April-September, 2005. The benchmark prime lending rates (BPLRs) of public sector banks, private sector banks and foreign banks remained unchanged in the range of 10.25-11.25 per cent, 11.00-13.50 per cent and 10.00-14.50 per cent, respectively.

24. The risk premium on private sector bonds, as measured by the yield spread between highly rated corporate paper and government securities, has increased. For example, the yield spread between AAA-rated corporate bonds of

5 years and government securities of similar maturity increased from about 34 basis points in April to about 47 basis points by October 21, 2005.

25. Equity market activity recorded a pick-up in terms of issuances in the domestic primary segment as well as in international stock exchanges. The BSE Sensex recovered from weak sentiment in April and rallied with intermittent corrections in the successive months. The Sensex rose to a new peak of 8800 on October 4, 2005 after which it registered some decline.

Developments in the External Sector

26. India's exports during April-September, 2005 increased by 20.5 per cent in US dollar terms as compared with 30.8 per cent in the corresponding period of the previous year. India's merchandise export growth surpassed that of most Asian countries during this period. Imports rose by 33.1 per cent as against an increase of 37.3 per cent in the corresponding period last year. While oil import growth moderated to 42.9 per cent from 58.2 per cent a year ago, non-oil import growth of 28.8 per cent was comparable to 29.8 per cent last year. The overall trade deficit during April-September 2005 widened to US $ 20.3 billion from US $ 11.9 billion a year ago, reflecting the hardening of international crude oil prices and more significantly, import demand emanating from a pick-up in domestic industrial activity.

27. During April-August, 2005 export growth was broad-based at a disaggregated level, but mainly led by manufactures such as engineering goods (28.9 per cent), gems and jewellery (23.9 per cent) and chemicals (21.8 per cent). Within engineering goods, machinery and instruments, transport equipment and manufactures of metals recorded acceleration of growth. Exports of petroleum products remained buoyant as in the preceding two years. Exports to developing countries in Asia increased by about 34.4 per cent. Among the major partner countries, significant increases in exports were recorded in respect of Latin America, Singapore, China, South Korea, Hong Kong, the Netherlands, France and the UK. As regards imports, non-oil imports excluding gold and silver rose by 36.7 per cent during April-August, 2005 led by imports of industrial inputs. Within the latter category, imports of capital goods posted a growth of 33.5 per cent, while imports of iron and steel surged by 109.9 per cent, both reflecting the sustained expansion of domestic demand. In terms of sources of imports, China, Switzerland, the US, Belgium, Germany, the UAE and Australia were the major trade partners. With the large expansion in non-oil imports, the

non-oil trade deficit rose to US $ 4.8 billion in April-August, 2005 from US $ 0.2 billion a year ago.

28. During 2004-05, the current account recorded a deficit of US $ 6.4 billion after remaining in surplus over the preceding three years beginning in 2001-02. A key factor underlying the phenomenon of current account balances has been the buoyancy in net invisible earnings which has been sustained in the current financial year so far. Nevertheless, the sharp widening of the trade deficit resulted in the current account recording a deficit of US $ 6.2 billion in April-June 2005 as against a surplus of US $ 3.4 billion in the corresponding quarter of 2004-05.

29. Net capital flows remained buoyant in April-June, 2005 due to surge in both debt and non-debt inflows. Foreign direct investment flows increased to US $ 1.1 billion from US $ 0.7 billion a year ago. Debt flows (net) in the form of external assistance, external commercial borrowings, non-resident deposits and short-term credit declined to US $ 1.1 billion in April-June 2005 from US $ 2.1 billion a year ago. Although investment by foreign institutional investors (FIIs) was subdued in the first two months of 2005-06, there has been a significant revival since then with net inflows of US $ 4.2 billion in April-September, 2005 as against US $ 0.3 billion in the corresponding period of 2004-05. Net accretion to foreign exchange reserves, including valuation changes, amounted to US $ 1.9 billion during April-October, 2005 taking the level of the reserves to US $ 143.4 billion as on October 14, 2005.

30. The Indian foreign exchange market has generally witnessed orderly conditions during the current financial year so far. The exchange rate of the rupee, which was Rs.43.75 per US dollar at end-March, 2005 depreciated by 3.0 per cent to Rs.45.09 per US dollar by October 21, 2005. However, it appreciated by 4.2 per cent against the Euro, by 2.5 per cent against the Pound sterling and by 4.5 per cent against the Japanese yen during the period.

31. The payment obligation on account of the redemption of India Millennium Deposits (IMDs) of about US $ 7.1 billion is due in December 2005. The Reserve Bank is closely co-ordinating with the State Bank of India (SBI) and other banks, and it would be ensured that the discharge of liabilities has no adverse impact on the Indian financial market.

32. There are significant shifts within the balance of payments which have implications for the conduct of monetary policy. With the import-GDP ratio having

risen to 17.2 per cent in 2004-05 after hovering around 13.0 per cent during the previous five years, the trade deficit is emerging as the key determinant of India's balance of payments. Although overall earnings from net invisibles have been buoyant, the large turnaround in the current account balance during 2004-05 and the first quarter of 2005-06 to a deficit from a continuous run of surpluses in 2001-04 has entailed expanded external financing requirements in the form of a step-up in recourse to debt flows and a distinct moderation in the accretion to the reserves.

33. The strength of merchandise and invisible exports is a heartening feature in India's balance of payments prospects. While the recent trend in imports may continue to persist in the face of high and volatile crude oil prices and the large increase in investment demand, the sizeable expansion in imports is also spurring productivity increases and vigorous export growth. Moreover, remittances from Indians employed abroad at 3.3 per cent of GDP seem to be of a significantly permanent nature. It is in this context that the current level of the trade deficit and the current account deficit appear to be manageable through normal capital flows. In view of the simultaneous hike in oil prices and continued strong investment demand, however, the evolving developments in the balance of payments warrant careful and continuous monitoring. The substitution of debt by non-debt flows in preceding years gives room for manoeuvre since debt levels, particularly external commercial borrowings, have been moderate. The emphasis would continue to be on encouraging inflows through foreign direct investment and enhancement of the quality of portfolio flows. Prudential oversight over financial intermediaries, especially banks, in respect of their foreign exchange exposures and transactions are a dynamic component of management of the capital account as well as financial supervision, especially as the process of financial liberalisation gains momentum.

Developments in the Global Economy

34. Global economic activity slackened in the second quarter of 2005, stalled by weak growth in the Euro area and Japan though domestic demand was sustained in the US. In emerging Asia - led by China and India - as well as in several developing countries in Latin America, the Middle East and Russia, growth has been robust. High and volatile international crude prices, global macroeconomic imbalances, international currency movements and the increasingly divergent growth profiles across regions have dampened the prospects for global recovery which had firmed up in the first half of 2004 and in

the first quarter of 2005. The International Monetary Fund (IMF) expects global output growth to slow down, *albeit* moderately, to 4.3 per cent in 2005 from 5.1 per cent in 2004.

35. Elevated levels of international crude prices have driven up consumer price inflation in most of the advanced economies in the third quarter of 2005 though it has remained stable in Japan. Inflation has also risen in major emerging market economies and other developing countries. In emerging Asia, consumer price inflation has edged up in almost all countries except China. The hardening of energy, metals and minerals prices seems to have imparted some upward push to inflation. The rise in oil prices has triggered fears of generalised inflationary pressures globally.

36. Oil prices remain the single largest risk to the global economy, exacerbated by the continued increase in global demand, geopolitical uncertainties, strong refining demand and a series of supply disruptions. Worldwide petroleum demand growth is projected to remain strong during 2005 and 2006 and tepid production growth is expected in non-OPEC countries, leaving spare production capacity at its lowest level in three decades. Though there has been build-up in inventory levels in the OECD countries in the first half of 2005, demand has grown rapidly as well. A large component of the oil price increase is now being reckoned as permanent which needs to be eventually passed on to the consumers in the medium-term. Governments in some countries have tried to partially insulate their economies from rising oil prices by subsidising the use of energy. A cut in the subsidy in the future, while being desirable, could lead to significant increase in domestic inflation and higher interest rates in the short-term.

37. Risks to global growth also emanate from the persisting macroeconomic imbalances and the resulting abundance of global liquidity which carries the potential of fuelling asset bubbles, excessive leveraging in financial markets and threats to global financial stability. The current configuration of good growth, low inflation, abundant liquidity, flat yield curves, lowering of credit risk premia and ever-expanding search for yields has also benefited many emerging market economies which have strengthened their macro-fundamentals in an environment of low inflation, improved fiscal positions and balance of payments and substantial accumulation of foreign exchange reserves. On the downside, the same combination of factors has allowed the macro imbalances to widen and has resulted in a build-up of large volumes of debt, especially by the household

sector. This has amplified the potential for sudden shifts in portfolios, investor preferences and currency alignments. The addition to global saving as a result of the increase in surpluses of oil exporters has enabled persistence of under-pricing of risks and a diffusion of risks across sectors. These factors have imparted an apparent stability to the financial system while sowing seeds of potential disequilibrium that might require a larger adjustment at a later stage. In the light of these developments, available evidence indicates that global imbalances have not really unwound but on the contrary, have perhaps worsened and amplified the surrounding uncertainties and risks.

38. Of the major central banks, the US Fed has raised its policy rate by 25 basis points each on eleven occasions from 1.0 per cent in June 2004 to 3.75 per cent by September 2005 while providing clear indications of a measured rise in the policy rate in the near term. The Bank of England has reduced its repo rate to 4.50 per cent in August 2005 in response to slowing domestic growth, after holding it steady at 4.75 per cent since August 2004. The European Central Bank (ECB) has kept its policy rate unchanged at 2.0 per cent since June 2003. Monetary policy has been tightened in several economies in emerging Asia, primarily in response to higher fuel prices. The indications in policy debates are towards either tightening or withdrawal of the accommodative stance.

39. The state of flux characterising global macroeconomic and financial conditions has confronted the conduct of monetary policy in various parts of the world with a similar spectrum of uncertainties and shifts therein. In fact, policy decision making in all countries has had to contend with difficulties of distinguishing news from noise in monitoring variables that are used to gauge the state of economic activity and the evolution of financial markets. This has made the dilemmas facing monetary policy sharper and policy errors costlier than before. In turn, this has brought about considerable cross-fertilisation and convergence in policy settings, choice of instruments and communication strategies. For monetary authorities vested with multiple objectives, the challenge is to continually rebalance the weights assigned to each, from as informed a judgment call as is feasible, given the prevailing uncertainties. Considerations of financial stability have, in particular, become a distinct dimension in the conventional trade-off between growth and price stability. Superimposed upon these overarching issues are country-specific factors which warrant tailored policy responses. For India, the linkages with the rest of the world in the context of the growing integration with the global economy are getting stronger and accordingly, global developments are becoming increasingly significant.

Nevertheless, the evolution of domestic conditions of high growth with price stability, stable and vibrant financial markets and institutions, comfortable foreign exchange reserves and the entrenchment of democratic processes provide room for flexible and timely responses to the evolving circumstances in an uncertain external environment.

II. Stance of Monetary Policy for the Second Half of 2005-06

40. The First Quarter Review on July 26, 2005 reiterated the stance of the Annual Statement on Monetary Policy on the basis of a broadly unchanged assessment of the macroeconomic outlook. It, however, noted that increased global uncertainties, high and volatile international prices of oil, incomplete pass-through of oil prices domestically, upward trajectory of the policy rate in the US, overhang of liquidity, high credit growth, sustained industrial growth and possible capacity pressures, enlargement of the trade deficit, infrastructural constraints and delayed monsoon could prompt a change in the stance of policy. On the other hand, the monetary and fiscal measures to mitigate the impact of the oil price hike, increase in absorptive capacity of the economy, broad-based credit flow, revival in industrial growth after a long period of sluggishness, pick-up in investment demand and favourable investment climate, sustained corporate earnings and profits, moderate wholesale and retail inflation and projection of moderate global inflation for 2005 despite high oil prices favoured *status quo* on the monetary policy stance while monitoring the unfolding constellation of uncertainties, especially in the global arena.

41. The conduct of monetary policy during the first half of 2005-06 has been broadly in accordance with the stated stance. On balance, macroeconomic and financial conditions have evolved as anticipated. First, overall industrial growth has strengthened *albeit* with infrastructure emerging as a potential constraint. Second, monsoon fears have eased although the full effects on agricultural production would depend on the spatial distribution of rainfall, the impact of the initial delay in the onset of the monsoon and excess rainfall in the last week of July 2005. Third, non-food credit growth has been buoyant, broad-based and supportive of the acceleration in industrial activity. Nevertheless, the rising shares of housing and real estate, in particular, has warranted precautionary policy action to ensure credit quality. Fourth, the demand for government securities from insurance companies and other non-bank financial institutions

has been sustained and the competing demand for funds between the government and the commercial sector has been balanced by appropriate liquidity management by the Reserve Bank. Fifth, a pick-up in investment demand is evident and the business climate has improved considerably with external demand providing impulses of growth for a range of industries.

42. As regards the commitment to macroeconomic and price stability, there have been several developments that have reinforced the policy stance. First, monetary conditions have evolved in an orderly manner. Money supply remained below the projected trajectory in the first four months of the current financial year, though it has inched up during the last two months due to rapid credit expansion. Reserve money growth has been somewhat higher than in the previous year. Demand deposits have recorded strong growth *pari passu* with the expansion of non-food credit, compensating for the slower growth of time deposits. The slowdown in net bank credit to the Government sector has helped in accommodating the surge in credit to the commercial sector. Second, there has been a supportive response of liquidity management by the Reserve Bank to portfolio shifts of market participants. Liquidity mismatches have been met in an orderly manner with the flexibility available, particularly under the LAF mechanism and operation of MSS. Third, the pass-through of the escalation in international crude prices to domestic petroleum product prices has been managed well and timed into the ebbing phase of inflation. Accordingly, the inflationary outcome has so far turned out to be consistent with initial projections and inflationary expectations are contained. Fourth, financial markets have remained stable and supportive of growth. Fifth, even as high oil prices and domestic demand emanating from buoyant industrial activity have resulted in a significant widening of the trade deficit, this has automatically absorbed the capital flows and economised on monetary policy action to sterilise these flows. At the same time, the rising international competitiveness of India's invisible exports and remittances from Indians working overseas have ensured that the current account deficit remains within manageable limits.

43. Several factors posing risks to the outlook on growth and inflation have, however, emerged in the recent months. First, it would be prudent to recognise the need to ensure credit quality in light of the high expansion of non-food credit so that a positive investment climate prevails with minimal risks and constraints. Second, infrastructure has emerged as a major bottleneck for development and the pace of investment in infrastructure needs to pick up further to support growth

in the long-term. Despite high non-food credit growth, the share of credit to infrastructure remains low relative to the size and state of the economy. Third, inflation is low in terms of commodity prices but asset prices, especially housing prices, have registered a substantial increase. Asset price changes can have a powerful effect on investment and/or consumption through a financial accelerator effect and in this context, large swings in asset prices continue to pose a challenge for monetary policy. From an analytical perspective, especially in view of non-linearities in asset price changes, such a high growth needs to be monitored carefully. Fourth, global crude oil prices continue to be high and volatile and an overwhelming part of the increase in recent years is now increasingly being regarded as permanent. So far, the second round impact of the increase has not been as strong as anticipated earlier but withholding of prices by companies treating the increase as a transitory supply shock will slowly have to give way. Given the persistent nature of the oil price increase, the possibility of a larger pass-through cannot be ruled out. The oil economy, nevertheless, poses a serious challenge to sustaining low inflationary expectations. Fifth, the trade deficit has been widening with the surge in imports, both oil and non-oil, but the invisible surplus and capital inflows have ensured a comfortable balance of payments situation. No doubt, evolving magnitudes of the current account deficits need to be recognised even though they are manageable. The level of foreign exchange reserves provides some comfort on this front though the situation needs a careful watch. Sixth, international interest rates cycles had so far shown mixed behaviour but currently the general indications are that the accommodative stance is being withdrawn and, in some cases, may be tightened. This has implications for capital flows. Nevertheless, the overall positive sentiment, the business confidence of the private sector and the strength as well as resilience of the domestic economy would continue to be the major determinants of capital flows. Ultimately, the approach to managing the external sector, the choice of instruments and the timing and sequencing of policies are matters of informed judgement. All these factors warrant close monitoring for sustaining the growth process with a tolerable level of inflation.

44. In the context of the evolving scenario for the oil economy, some key features merit clear recognition. First, at this stage of development, current levels of energy intensity of the Indian economy are likely to persist over the medium-term. Second, although attention has increasingly turned to conservation, energy saving devices are not likely to yield substantial gain in the short- to medium-term. Third, the level of domestic supplies of crude petroleum has stagnated over

the past few years and significant increases are not envisaged in the immediate future. Furthermore, increases in global supplies are expected to be modest in view of capacity constraints. Fourth, global demand for petroleum products is expected to remain robust. The combined impact of these factors could result in a compositional shift in the supply side in favour of coal and gas, but the reliance on petroleum will continue to grow significantly. Accordingly, persistence of the Indian economy's sizeable dependency on imports of petroleum and products is inevitable. Under these conditions, it is necessary to prepare for some further adjustments in relative prices. Thus, upside inflationary pressures from oil prices can be expected to continue with attendant direct and indirect effects. So far, there has been only partial pass-through of international crude prices into domestic prices of petroleum products and second round effects have not yet become noticeably significant. At this stage, therefore, it is necessary to contain inflationary expectations in response to the evolving oil scenario and continue to take measures in a forward looking manner.

45. In Section I of this Part, detailed analysis has been presented on the likely levels of major macroeconomic and monetary aggregates after assessing the relevant factors. In view of these and for the purpose of monetary management: (i) based on the current assessment of a pick-up in agricultural output and in the momentum in industrial and services sectors, GDP growth in 2005-06 is placed in the range of 7.0-7.5 per cent against around 7.0 per cent as projected earlier; and (ii) the commitment to price stability has earned some success during the year so far. Given the outlook for inflation primarily in the context of the oil economy in India, however, it may be difficult to contain the inflation in the range of 5.0-5.5 per cent projected earlier without an appropriate policy response. It is also necessary to recognise and formulate a forward looking policy response in a manner that the growth momentum and the potential for higher growth is realised without adding to inflation expectations. Accordingly, expansion in M3 would be somewhat higher than 14.5 per cent projected earlier and growth in aggregate deposits would be higher than Rs.2,60,000 crore projected earlier. Non-food bank credit including investments in bonds/debentures/shares of public sector undertakings and private corporate sector, commercial paper (CP), etc., is expected to increase significantly, higher than 19.0 per cent projected earlier. There are several factors that warrant continuous vigilance for ensuring macroeconomic and financial stability which is critical for maintaining the growth momentum. While rapid growth in non-food credit requires due diligence, the oil economy and price changes would also need careful monitoring for reining in

inflationary expectations. The level of capacity utilisation is high and in the current phase of economic growth, capacity expansion in the Indian industry needs to be supported. The liquidity position continues to be comfortable, providing some flexibility to support the investment and export demand in the economy to maintain the growth momentum without undue pressure on prices and in this context, monetary policy would continue to strive for maintaining stable inflationary expectations and orderly financial markets while ensuring the continuation of the positive investment climate.

46. Against the backdrop of developments during 2005-06 so far, the stance of monetary policy would depend on the macroeconomic developments including the global scenario. A key factor is the assessment of the risks in as accurate a manner as is feasible. Globally, the major risks are from heightened uncertainties associated with the unwinding of macroeconomic imbalances and consequent currency adjustments as well as the future course of international crude prices. A significant part of the oil price rise, which is currently being treated as permanent, would result in higher pass-through and, coupled with the secondary effect, poses a challenge for monetary policy. Domestically, the related adjustment of prices of petroleum products and second round effects on overall inflation, the rapid credit growth and potential for erosion in credit quality are factors that warrant careful and continuous monitoring. As regards the external sector, the growing trade deficit and its financing are relevant to the monetary policy stance. At the same time, there is need to recognise the favourable factors that characterise the Indian economy. The oil price hike has not seriously hampered growth prospects or significantly affected inflationary expectations so far. Investment demand is strengthening amidst a congenial business climate and corporate earnings and profits have been sustained.

47. In the annual policy Statement of April 2005, attention was drawn to several global uncertainties which complicate the conduct of monetary policy. In particular, it was indicated that the rise in oil prices appears to have a large permanent component which makes it important to factor in the second round effects in assessing the impact on inflation and growth. More recently, the large increase in export earnings of oil-exporting countries has added to the overhang of global liquidity which could accentuate inflationary pressures if capacity pressures emerge and market conditions tighten. Second, in the context of the inflation scenario, the turning up of the interest rate cycle was expected to weigh heavily on the outlook for

financial stability. Third, risks to global growth were also seen in the incomplete and delayed adjustment of major currencies to the global imbalances. At the current juncture, it appears that some of these uncertainties seem to be materialising, resulting in rising inflation expectations and the withdrawal of accommodation in the monetary policy stance in several economies. While in India, the domestic factors continue to prevail over global factors, suggestive of continued preference for stability, recent domestic developments add to the case for a prompt policy response. While responding appropriately to the current situation, it is necessary to be in readiness to take further measures as warranted to meet the challenges posed by the evolving situation, given the unfolding of the risks.

48. It is necessary, both for policy makers and market participants, to recognise interest rate cycles and strengthen risk management processes to cope with eventualities so that financial stability could be maintained and interest rate movements could be transited in a non-disruptive manner. In this regard, it is instructive to observe global trends as the Indian economy is progressively getting linked to the world economy. While domestic liquidity, partly mirroring global liquidity, is critical, the trends in global interest rates, inflation expectations and investment demand would also have some relevance in the evolution of domestic interest rates. It will, therefore, be desirable to contain inflationary pressures to stabilise domestic financing conditions both for the government and the private sector.

49. The Reserve Bank will continue to ensure that appropriate liquidity is maintained in the system so that all legitimate requirements of credit are met, consistent with the objective of price stability. Towards this end, RBI will continue with its policy of active demand management of liquidity through OMO including MSS, LAF and CRR, and using all the policy instruments at its disposal flexibly, as and when the situation warrants.

50. In sum, barring the emergence of any adverse and unexpected developments in various sectors of the economy and keeping in view the current assessment of the economy including the outlook for inflation, the overall stance of monetary policy for the remaining part of the year will be:

- Consistent with emphasis on price stability, provision of appropriate liquidity to meet genuine credit needs and support export and investment demand in the economy.

- Ensuring an interest rate environment that is conducive to macroeconomic and price stability, and maintaining the growth momentum.

- To consider measures in a calibrated and prompt manner, in response to evolving circumstances with a view to stabilising inflationary expectations.

III. Monetary Measures

(a) Bank Rate

51. In the annual policy Statement of April 2005, the Bank Rate was kept unchanged at 6.0 per cent. On a review of the macroeconomic developments, it is considered desirable to leave the Bank Rate unchanged at 6.0 per cent.

(b) Reverse Repo Rate

52. In view of the current macroeconomic and overall monetary conditions, it has been decided:

- to increase the fixed reverse repo rate under the liquidity adjustment facility (LAF) of the Reserve Bank by 25 basis points with effect from October 26, 2005 to 5.25 per cent from 5.0 per cent.

53. The repo rate will continue to be linked to the reverse repo rate. The spread between the reverse repo rate and the repo rate has been retained at 100 basis points, as at present. Accordingly, the fixed repo rate under LAF will be 6.25 per cent, effective October 26, 2005.

(c) Cash Reserve Ratio

54. The cash reserve ratio (CRR) of scheduled banks is currently at 5.0 per cent. While the Reserve Bank continues to pursue its medium-term objective of reducing the CRR to the statutory minimum level of 3.0 per cent, on a review of the current liquidity situation, it is felt desirable to keep the present level of CRR at 5.0 per cent unchanged.

Third Quarter Review

55. The Third Quarter Review of this part of the annual policy Statement will be undertaken on Tuesday, January 24, 2006.

Part II. Mid-term Review of Annual Statement on Developmental and Regulatory Policies for the year 2005-06

56. The annual policy Statements as well as mid-term Reviews of the Reserve Bank have progressively sharpened the focus on developmental and regulatory policies to strengthen the financial system with a view to ensuring financial stability as a prerequisite for high and stable growth. Rapid changes in technology and the impact of globalisation have necessitated prudent and forward looking policy initiatives for the maintenance of financial stability. The Reserve Bank's approach has been to reorient its role in the context of the evolving conditions for improving institutional soundness, strengthening the regulatory and supervisory processes and developing the necessary legal and technological infrastructure. While the functions of financial sector regulation and supervision emphasise efficiency, stability and soundness of regulated entities and markets, they also aim at developing a system that is responsive to the needs of all sections of society. In this context, the Reserve Bank is continually broadening its consultative and participative process for wider involvement of all stakeholders in the financial system with a view to encouraging a more informed evaluation of the underlying content of policies.

57. In the context of entrenching financial stability in India, the mid-term Review focuses on certain key areas. First, it is essential to take adequate measures for enhancing delivery of appropriate credit at a reasonable price. Second, there is a need to further develop financial markets and enhance the integration of various segments of the financial markets with proper checks and balances. Third, within the emphasis assigned to credit delivery to agriculture and the small and medium enterprise (SME) sector, developing a conducive environment for micro-finance institutions (MFIs) to cover financial services in addition to credit requires specific attention. Fourth, with a view to ensuring financial inclusion of all segments of the population, in both rural and urban areas, a comprehensive framework to revive the co-operative credit system, revitalise the regional rural banks (RRBs) and reorient commercial banking towards the credit-disadvantaged sections of society assumes high priority. Finally, in order to safeguard systemic stability, sound corporate governance practices, sophisticated risk management techniques and implementation of prudential measures in the financial sector in harmony with global developments need to be focused on. In this regard, there is some merit in assessing the

prudential guidelines in the light of developments in business cycles and systems of pricing of risks in different segments. Managing risk-based capital requirement and ensuring robustness of the risk management as well as risk-pricing systems assume importance.

58. The mid-term Review of the Annual Statement on Developmental and Regulatory Policies for the year 2005-06 assesses the progress of measures already taken and proposes some further measures under five sections: I. Interest Rates; II. Financial Markets; III. Credit Delivery Mechanisms; IV. Prudential Measures; and V. Institutional Developments.

I. Interest Rates

Interest Rate Policy

59. The annual policy Statement of April 2005 recognised that there is merit in further deregulation of interest rates in those segments which have remained regulated for reasons relevant at different stages. It proposed, however, to continue with the *status quo* as various issues pertaining to regulations on interest rates were being debated. In this context, the Reserve Bank constituted an Internal Working Group on NRI Deposits which submitted its report in September 2005. Furthermore, the Indian Banks' Association (IBA) has been requested to constitute technical groups for preparation of discussion papers on review and deregulation of interest rate on savings bank deposits and lending rates on small loans up to Rs.2 lakh.

BPLR System: Review

60. Pursuant to the announcement made in the mid-term Review of November 2003, the IBA advised its member banks to announce a benchmark prime lending rate (BPLR), with the approval of their boards, keeping in view the operational requirements. Furthermore, banks were allowed to freely price their loan products below or above their BPLR and offer floating rate products by using market benchmarks in a transparent manner. Banks were also encouraged to align the pricing of credit to their credit risk assessment so that both credit delivery and quality improves.

61. Over the period, however, the system of BPLR has evolved in a manner that has not fully met these expectations. Competition has forced the pricing of a significant proportion of loans far out of alignment with BPLRs and in a non-

transparent manner. As a consequence, this has undermined the role of the BPLR as a reference rate. Furthermore, there is a public perception that there is underpricing of credit for corporates while there could be overpricing of lending to agriculture and small and medium enterprises. Several requests have also been received by the Reserve Bank from banks suggesting a review of the BPLR system. Therefore, a need has arisen to review the current procedures and processes of pricing of credit through a well structured and segment-wise analysis of costs at various stages of intermediation in the whole credit cycle. Accordingly, the IBA may, in consultation with its member banks, review the BPLR system afresh and issue transparent guidelines for appropriate pricing of credit.

II. Financial Markets

Money Market

Framework for Development of Money Market

62. As indicated in the annual policy Statement of April 2005, the report of the Technical Group on Money Market was placed on the Reserve Bank's website for wider dissemination. A screen-based negotiated quote-driven system for all dealings in call/notice and term money markets and an electronic trading platform for conduct of market repo operations in government securities, in addition to the existing voice-based system, are being developed by the Clearing Corporation of India Ltd. (CCIL). Furthermore, information on commercial paper (CP) issuance as reported by the issuing and paying agents (IPA) on the negotiated dealing system (NDS) platform, has been made available on the Reserve Bank's website with effect from July 2005 to enhance transparency and facilitate wider dissemination. The recommendations of the Group on introduction of asset-backed commercial paper (ABCP), introduction of additional intra-day LAF and optionalities in OTC rupee derivatives are under examination.

Government Securities Market

(a) Central Government Securities Market

63. On the basis of the recommendations of the Technical Group on Central Government Securities Market, the annual policy Statement of April 2005 indicated that in the post-Fiscal Responsibility and Budget Management (FRBM) Act period, the Reserve Bank will reorient government debt management

operations while simultaneously strengthening monetary operations in order to prepare for withdrawing from primary financing of the Central Government's borrowing programme, effective April 2006. Accordingly, the Reserve Bank has constituted a new department named as Financial Markets Department (FMD) in July 2005 with a view to moving towards functional separation between debt management and monetary operations. To begin with, the functions of the FMD include open market operations (OMO), the liquidity adjustment facility (LAF), market stabilisation scheme (MSS) and standing liquidity facilities; regulation and development of money market instruments and monitoring of money, government securities and foreign exchange markets. The functions of the FMD would also cover the Reserve Bank's operations in the domestic foreign exchange market, in due course, in order to achieve the desired integration with conduct of monetary operations.

64. The recommendations of the Technical Group relating to restructuring the underwriting obligations of primary dealers (PDs), allowing PDs exclusivity in primary auctions, introduction of 'When Issued Market' and limited short selling in government securities were examined by the Reserve Bank in consultation with the Government. Accordingly, as a first step, it is proposed:

- to introduce intra-day short selling in government securities. Guidelines in this regard would be issued separately.

(b) Operationalisation of Electronic Trading Platform

65. As indicated in the annual policy Statement of April 2005, a screen-based order-driven anonymous NDS Order Matching (NDS-OM) Module has been operationalised in August 2005. In the first phase, the NDS-OM module has been introduced for RBI-regulated NDS members. By end-September 2005, 117 members were active in the module with NDS-OM volumes covering about two-thirds of the total outright transactions in dated government securities in the secondary market. It is now proposed:

- to extend NDS-OM module to all insurance entities which are mandated to invest in government securities. Guidelines in this regard would be issued separately.

(c) Revision of WMA/Overdraft Scheme for State Governments: Status

66. The Committee on Ways and Means Advances (WMA) to State Governments (Chairman: Shri C. Ramachandran) had recommended *inter alia* that the formula and the limits of WMA may be reviewed in totality after the receipt of the recommendations of the TFC. Accordingly, an Advisory Committee to Review the WMA Scheme was constituted in April 2005 (Chairman: Shri M.P. Bezbaruah). The Committee would submit its report shortly. The report would then be discussed with the State Governments.

Foreign Exchange Market

(a) Forex Market: Medium-term Framework

67. As indicated in the annual policy Statement of April 2005, the report of the Internal Group on Forex Market was placed on the Reserve Bank's website for wider dissemination. The recommendations of the Group, particularly those on writing of covered options by corporates, hedging of economic risk of corporates in respect of their domestic operations arising out of changes in the landed cost of the imported substitutes of the commodities they consume/produce and crystallisation of overdue export bills are under examination.

(b) External Commercial Borrowings: Expansion

68. Currently, external commercial borrowings (ECBs) proposals of financial institutions dealing exclusively with infrastructure or export refinance such as Infrastructure Development Finance Company, Power Finance Corporation, Power Trading Corporation, Indian Railway Construction Company and Exim Bank are considered by the Reserve Bank on a case-by-case basis under the approval route. It is clarified that:

- Special purpose vehicles (SPVs) or any other entity notified by the Reserve Bank, which are set up to finance infrastructure companies/projects, would be treated as financial institutions and ECBs raised by such entities would be considered under the approval route.

69. With a view to facilitating capacity expansion and technological upgradation in the Indian textile units after phasing out of the Multi-Fibre Agreement, it is proposed:

- to allow banks to issue guarantees or standby letters of credit in respect of ECBs raised by textile companies for modernisation or

expansion of textile units. Such applications would be considered under the approval route subject to prudential norms.

III. Credit Delivery Mechanisms

(a) Flow of Credit to Agriculture

70. It has been the endeavour of the Reserve Bank to improve the agricultural credit delivery mechanism to enable banks to provide adequate and timely finance at reasonable rates. As indicated in the annual policy Statement of April 2005, most of the recommendations of the Advisory Committee on Flow of Credit to Agriculture and Related Activities from the Banking System (Chairman: Prof. V.S. Vyas) have been implemented by the Reserve Bank and the National Bank for Agriculture and Rural Development (NABARD). A few recommendations of the Committee are under examination of the Government. Public sector banks are required to formulate special agricultural credit plans (SACP) in order to achieve distinct improvement in the flow of credit to agriculture. During 2004-05, disbursements to agriculture by public sector banks under SACP aggregated Rs.65,218 crore against the projection of Rs.55,616 crore. By end-June 2005, public sector banks had issued 183.5 lakh kisan credit cards (KCCs) with aggregate limits amounting to Rs.62,000 crore. As announced in the Union Budget for 2005-06, the Rural Infrastructure Development Fund (RIDF) XI has been established with the NABARD with a corpus of Rs.8,000 crore. Cumulative sanctions and disbursements till August 2005 under various tranches of RIDF (I to XI) amounted to Rs.44,389 crore and Rs.26,693 crore, respectively.

(b) Priority Sector Lending

71. It was indicated in the annual policy Statement of April 2005 that prescriptions on eligibility criteria and other aspects relating to priority sector lending need to be reviewed and examined in depth. In this context, an Internal Working Group (Chairman: Shri C. S. Murthy) was set up by the Reserve Bank to review the existing policy on priority sector lending including the segments constituting the priority sector, targets and sub-targets and recommend changes as necessary. The draft technical paper of the Group has been placed on the Reserve Bank’s website for wider dissemination and comments. The technical paper has also been sent to the Government and the IBA for their views.

(c) Credit Flow to Small and Medium Enterprises

72. As a sequel to the announcement made by the Hon’ble Finance Minister in the Parliament on August 10, 2005 in regard to a policy package for stepping up credit to small and medium enterprises, banks were advised to take action as under:

- Units with investment in plant and machinery in excess of the small scale industries (SSI) limit and up to Rs.10 crore would be treated as medium enterprises (ME) and only SSI financing would be included in priority sector lending.
- Banks would fix their own targets for financing the SME sector so as to reflect a higher disbursement over the immediately preceding year, while the sub-targets for financing tiny units and smaller units to the extent of 40 per cent and 20 per cent, respectively, would continue.
- Banks would initiate necessary steps to rationalise the cost of loans to the SME sector by adopting a transparent rating system with the cost of credit linked to the credit rating of the enterprise.
- Banks should make concerted efforts to provide credit cover, to at least five new small/medium enterprises per year on an average, at each of their semi urban/urban branches.
- Boards of banks would formulate liberal and comprehensive policies for extending loans to the SME sector.
- Banks should increasingly adopt the cluster-based approach for financing the SME sector.
- Banks would ensure presence of specialised SME branches in identified clusters/centres with preponderance of medium enterprises to provide SME entrepreneurs easy access to bank credit and also equip their personnel with requisite expertise. The existing specialised SSI branches would also be redesignated as SME branches. Though their core competence will be utilised for extending finance and other services to the SME sector, they will also have operational flexibility to extend finance/render other services to other sectors/borrowers.

- Policy guidelines formulated by the boards of banks, all facilities/schemes offered by them to small entrepreneurs and instructions/guidelines issued by the Reserve Bank should be displayed on the websites of banks, the SIDBI and at each bank branch for wider dissemination and easy accessibility.

73. The Reserve Bank has constituted empowered committees at its regional offices to review the progress in SME financing and rehabilitation of sick SSI and ME units so as to ensure smooth flow of credit to these sectors. The Reserve Bank has also formulated a one-time settlement scheme for recovery of non-performing assets (NPAs) below Rs.10 crore for SME accounts and detailed guidelines have been issued to public sector banks for implementation. A debt restructuring mechanism for units in the SME sector, in line with the corporate debt restructuring (CDR) mechanism prevailing in the banking sector, has been formulated by the Reserve Bank and guidelines were issued for implementation.

(d) Restructuring and Development of Regional Rural Banks

74. As indicated in the annual policy Statement of April 2005, an Internal Group (Chairman: Shri A. V. Sardesai) was set up by the Reserve Bank to examine various alternatives available within the existing legal framework for strengthening regional rural banks (RRBs) and making them viable rural financial institutions. The Group submitted its report in June 2005 which has been sent to the Government for comments. The major recommendations of the Group include merger/amalgamation of RRBs to improve operational viability, change of sponsor banks to enhance competitiveness, strengthening of balance sheets in respect of merged entities, regulatory and supervisory strengthening, governance and management and scope for improving profitability.

(e) Micro-finance

75. The programme of linking self-help groups (SHGs) with the banking system continues to be the major micro-finance programme in the country and is being implemented by commercial banks, RRBs and co-operative banks. By end-July 2005, as many as 16,53,047 SHGs were linked to banks and the total flow of credit to SHGs was Rs.7,063 crore.

76. The following measures have been initiated to give further impetus to the micro-finance endeavour:

- In pursuance of the Union Budget, 2005-06, the Micro Finance Development Fund (MFDF) set up in the NABARD has been redesignated as the Micro Finance Development and Equity Fund (MFDEF) and its corpus has increased from Rs.100 crore to Rs.200 crore. The modalities in regard to the functioning of the MFDEF are being worked out.

- The Internal Group (Chairman: Shri H.R. Khan) constituted by the Reserve Bank to examine issues relating to rural credit and micro-finance submitted its report in July 2005 which was placed on the Reserve Bank's website for wider dissemination. Important recommendations of the Group include providing comprehensive financial services in rural areas encompassing savings, credit, remittance, insurance and pension products and establishing linkages between banks and external entities based on two broad models, *viz.,* business facilitator model and business correspondent model. The Group has also suggested several steps to promote SHGs and micro-finance institutions (MFIs) which include future growth of SHG-Bank Linkage and MFI-Bank Linkage programmes, utilisation of MFDEF funds to facilitate formation of SHG federations for offering services like rural housing loans, micro-insurance and tie-up with service providers, development of accounting standards for SHGs and NGOs, capacity building of MFIs, rating of MFIs, development of rating models and training modules for MFIs. The recommendations of the Group are under examination.

(f) Revival of Rural Co-operative Banking Institutions and Long-term Co-operative Credit Structure

77. The Task Force appointed by the Government (Chairman: Prof. A. Vaidyanathan) to propose an action plan for reviving the rural co-operative banking institutions and suggesting an appropriate regulatory framework for these institutions submitted its report in February 2005. The Government has accepted the recommendations of the Task Force, in principle, and held consultative meetings with the State Governments. The Government has entrusted the work of studying the long-term co-operative credit structure for agriculture and rural development to the Task Force.

(g) Special Relief Measures by Banks in Areas Affected by Natural Calamities

78. The Reserve Bank has issued guidelines/instructions to banks in regard to relief measures to be provided in areas affected by natural calamities from time to time. These guidelines cover various relief measures pertaining to credit to existing borrowers, mainly in the agricultural sector. During recent calamities such as *tsunami*, heavy rains, floods and earthquakes in some parts of the country, a number of instances relating to functioning of ATMs, opening of accounts of small customers, operations of accounts in the absence of documents and failure of computer networks have come to the notice of the Reserve Bank. Accordingly, it is proposed to constitute an internal Working Group to examine the whole gamut of issues and suggest suitable revisions to the existing guidelines, with a view to making them comprehensive.

IV. Prudential Measures

(a) Capital Market Exposure Limits: Rationalisation

79. As per the current norms, a bank's aggregate exposure in all forms to the capital market should not exceed five per cent of its total outstanding advances (including commercial paper) as on March 31 of the previous year. Within this overall ceiling, the bank's investment in shares, convertible bonds and debentures and units of equity-oriented mutual funds should not exceed 20 per cent of its net worth. On a consolidated basis, the bank's aggregate exposure to capital markets should not exceed two per cent of its total on-balance-sheet assets (excluding intangible assets and accumulated losses) as on March 31 of the previous year. Within the total limit, investment in shares, convertible bonds and debentures and units of equity-oriented mutual funds should not exceed 10 per cent of the bank's consolidated net worth.

80. The Reserve Bank has undertaken a review of the prudential limits on the capital market exposure with a view to rationalising them in terms of base and coverage. Accordingly, it is proposed:

- to restrict a bank's aggregate capital market exposure to 40 per cent of the net worth of the bank on a solo and consolidated basis.
- to modify a bank's consolidated direct capital market exposure to 20 per cent of the bank's consolidated net worth.

- to simplify and rationalise the exemptions in regard to the coverage.

81. Banks exceeding these limits either on solo or consolidated basis should approach the Reserve Bank with a plan for bringing down the exposure within the permissible limits. Banks having sound internal controls and robust risk management systems can approach the Reserve Bank for higher limits. Guidelines in this regard would be issued separately.

(b) Prudential Provisioning Requirements: Review

82. In terms of the prudential guidelines, banks are required to assess their entire loans and advances portfolio on an account-by-account basis with regard to the degree of delinquency and classify them into four broad asset classification categories, *viz*., standard, sub-standard, doubtful and loss. The standard assets attract a uniform provisioning requirement of 0.25 per cent of the funded outstanding on a portfolio basis. Banks are required to make specific provisions in respect of sub-standard assets at a uniform rate of 10 per cent of the funded outstanding and for doubtful accounts at rates ranging from 20 to 100 per cent, taking into account the period for which the account has remained non-performing and the realisable value of security charged to the bank.

83. Traditionally, banks' loans and advances portfolio is pro-cyclical and tends to grow faster during an expansionary phase and grows slowly during a recessionary phase. During times of expansion and accelerated credit growth, there is a tendency to underestimate the level of inherent risk and the converse holds good during times of recession. This tendency is not effectively addressed by the above mentioned prudential specific provisioning requirements since they capture risk *ex post* but not *ex ante*.

84. The various options available for reducing the element of pro-cyclicality include, among others, adoption of objective methodologies for dynamic provisioning requirements, as is being done by a few countries, by estimating the requirements over a business cycle rather than a year on the basis of the riskiness of the assets, establishment of a linkage between the prudential capital requirements and through-the-cycle ratings instead of point-in-time ratings and establishment of a flexible loan-to-value (LTV) ratio requirements where the LTV ratio would be directly related to the movement of asset values.

85. Taking into account the recent trends in credit growth, it is proposed:

- to increase the general provisioning requirement for 'standard advances' from the present level of 0.25 per cent to 0.40 per cent. Banks' direct advances to agricultural and SME sectors would be exempted from the additional provisioning requirement. As hitherto, these provisions would be eligible for inclusion in Tier II capital for capital adequacy purposes up to the permitted extent. Operational guidelines in this regard would be issued separately.

(c) New Capital Adequacy Framework: Status

86. Draft guidelines for implementation of the New Capital Adequacy Framework have been formulated and placed on the Reserve Bank's website. In line with international standards, banks were advised to adopt the Standardised Approach for credit risk with effect from March 31, 2007. Banks adopting the Standardised Approach would use the rating assigned by only those credit rating agencies which are identified by the Reserve Bank. Accordingly, an in-house Group has been constituted in the Reserve Bank for identifying the external rating agencies. Final guidelines would be issued on the basis of the recommendations of the Group and the feedback received thereon.

87. Under the New Framework, banks are required to adopt the Basic Indicator Approach (BIA) for computing capital requirement for operational risk. The Reserve Bank has issued a 'Guidance Note on Management of Operational Risk' in October 2005 to facilitate a smooth transition to the New Framework. Banks using BIA are encouraged to comply with 'Sound Practices for the Management and Supervision of Operational Risk' issued by the Basel Committee on Banking Supervision (BCBS) in February 2003.

88. The BCBS has undertaken the Fifth Quantitative Impact Study (QIS-5) to assess the impact of adoption of New Capital Adequacy Framework. Twelve banks identified to participate in the QIS-5 were advised to familiarise themselves with the requirements of QIS-5 for effective participation.

(d) Capital Adequacy Requirements

89. Banks which have maintained regulatory capital of at least nine per cent of the risk weighted assets for both credit risk as well as market risk in respect of 'held for trading' (HFT) and 'available for sale' (AFS) categories as on March 31, 2006 would be permitted to treat the entire balance in the investment fluctuation

reserve (IFR) as Tier I capital. Once the amount of IFR is so transferred towards Tier I capital, a headroom for raising an equal amount of Tier II capital would become available to the eligible banks, up to half of which could be raised through issuance of subordinated debt.

90. In terms of the prudential guidelines on capital adequacy, banks are required to maintain capital charge for market risk in respect of their trading book exposures (including derivatives) and securities included under the AFS category with effect from March 31, 2005 and March 31, 2006, respectively. Furthermore, banks are required to migrate to the New Capital Adequacy Framework with effect from March 31, 2007. These developments would result in additional capital requirements for banks. Internationally, banks raise capital through equity shares and instruments such as subordinated debt and preference shares which are eligible for inclusion in Tier I/Tier II/Tier III capital. Banks in India, however, do not currently have such options available except for raising Tier II capital through subordinated debt to a limited extent. The Reserve Bank is examining various types of capital instruments that can be permitted under the New Capital Adequacy Framework.

(e) Corporate Debt Restructuring Mechanism

91. As mentioned in the annual policy Statement of April 2005, the performance of the corporate debt restructuring (CDR) mechanism was reviewed and draft guidelines on CDR mechanism were placed on the Reserve Bank's website in May 2005 for wider dissemination. The changes to the existing CDR scheme have been finalised taking into account the feedback received. Operational guidelines in this regard would be issued separately.

(f) Supervisory Review Process

92. Having regard to the recent trends in the credit markets it is proposed:

- to initiate a supervisory review process with select banks having significant exposure to some sectors, namely, real estate, highly leveraged NBFCs, venture capital funds and capital markets, in order to ensure that effective risk mitigants and sound internal controls are in place for managing such exposures.

(g) Financing of NBFCs

93. As indicated in the annual policy Statement of April 2005, an Informal Working Group (Chairperson: Smt. Usha Thorat) was constituted to examine the issues involved in financing of NBFCs by banks and suggest ways to use the core competencies of NBFCs in extending credit to small borrowers. The recommendations of the Group include: (i) extending bank finance to NBFCs for permissible activities; (ii) using NBFCs as business correspondents or agents; (iii) permitting banks to rediscount the bills discounted by NBFCs pertaining to the transport sector; (iv) using NBFCs as a conduit for providing long-term funds to the SME sector; and (v) extending training facilities to NBFCs engaged in financing the SSI and agriculture sectors. The recommendations are under examination.

(h) Credit Information Companies (Regulation) Act, 2005: Status

94. The Credit Information Companies (Regulation) Act, 2005 was notified in the Gazette of India on June 23, 2005 and the Government requested the Reserve Bank to frame rules and regulations for implementation of the Act. Accordingly, a Working Group (Chairman: Shri Prashant Saran) was constituted with representatives from the Reserve Bank, the IBA, the Credit Information Bureau of India Ltd. (CIBIL) and select banks. The Group, in consultation with the Ministry of Law, prepared the draft rules and regulations for implementation of the Act with specific provisions for protecting individual borrower's rights and obligations. The draft rules and regulations are being examined by the Reserve Bank.

(i) Setting up of Banking Codes and Standards Board of India: Status

95. Modalities regarding setting up of an independent Banking Codes and Standards Board of India (BCSBI) on the model of the mechanism in the UK are being worked out in pursuance of the annual policy Statement of April 2005 in order to ensure that a comprehensive code of conduct for fair treatment of customers is established.

(j) Financial Inclusion

96. The annual policy Statement of April 2005, while recognising the concerns in regard to the banking practices that tend to exclude rather than attract vast sections of population, urged banks to review their existing practices to align

them with the objective of financial inclusion. In many banks, the requirement of minimum balance and charges levied, although accompanied by a number of free facilities, deter a sizeable section of population from opening/maintaining bank accounts. With a view to achieving greater financial inclusion, all banks need to make available a basic banking 'no frills' account either with 'nil' or very low minimum balances as well as charges that would make such accounts accessible to vast sections of population. The nature and number of transactions in such accounts could be restricted, but made known to the customer in advance in a transparent manner. All banks are urged to give wide publicity to the facility of such a 'no-frills' account so as to ensure greater financial inclusion.

(k) Issue of Co-branded Debit Cards by Banks

97. At present, banks are required to obtain the Reserve Bank's approval for issue of debit cards in tie-up with other non-bank entities for marketing and distribution purposes. In order to further liberalise the procedure, it is proposed:

- to accord general permission to banks to issue debit cards in tie-up with non-bank entities subject to certain conditions. Detailed instructions would be issued separately.

(l) Anti-Money Laundering Guidelines: Status

98. In recent years, prevention of money laundering has assumed importance in international financial relationships. In this context, in November, 2004 the Reserve Bank revised the guidelines on 'Know Your Customer' (KYC) principles in line with the recommendations made by the Financial Action Task Force (FATF) on standards for Anti-Money Laundering (AML) and Combating Financing of Terrorism (CFT). Banks were advised to frame their KYC policies with the approval of their boards and ensure that they are compliant with its provisions by December 31, 2005. The salient features of the policy relate to the procedure prescribed in regard to customer acceptance, customer identification, risk management and monitoring of transactions. The revised guidelines envisage verification of the identity and address of the customer through independent source documents as mandatory and banks are required to classify the accounts according to their risk perceptions. In order to ensure that the inability of persons belonging to low income groups to produce documents to establish their identity and address does not lead to their financial exclusion and denial of banking services, a simplified procedure has been provided for opening of account in

respect of those persons who do not intend to keep balances above Rs.50,000 and whose total credit in one year is not expected to exceed Rs.1,00,000.

V. Institutional Developments

Payment and Settlement Systems

(a) Electronic Payment Products: Status and Proposed Action

99. The coverage of Real Time Gross Settlement (RTGS) system has increased significantly. As on October 19, 2005 RTGS connectivity was available in 11,280 bank branches at 508 cities. By end-March 2006, 15,000 branches are proposed to be covered and the number of monthly transactions of the system is expected to expand from one lakh to two lakh.

100. The National Electronic Funds Transfer (NEFT) system for electronic transfer of funds would be implemented in phases for all networked branches of banks all over the country. By end-December 2005, NEFT would be operationalised in 34 banks. By end-June 2006, the remaining banks are expected to be part of the system. Currently, the package for operationalisation of NEFT is being tested for implementation.

101. The pilot project for Cheque Truncation System, which aims at enhancing efficiency in the retail cheque clearing sector, is expected to be implemented in New Delhi by end-March 2006.

102. The clearing position of banks in various clearing houses would be settled centrally through a national settlement system (NSS) in order to enable banks to manage liquidity in an efficient and cost-effective manner. Accordingly, it is proposed to introduce NSS at the four metropolitan centres by end-December 2005.

103. One of the constraints in the growth of electronic payment systems has been the high rate of service charges being levied by banks. In this context, the Reserve Bank waived service charges on banks for both electronic clearing service (ECS) and electronic fund transfer (EFT) transactions up to March 31, 2006 with a view to promoting EFT and encouraging ECS. Furthermore, no service charge is being levied for RTGS transactions since its commencement and this waiver is also valid up to March 31, 2006. As electronic payment systems facilitate straight-through processing and are cost-effective in the long

run, banks are encouraged to review service charges being levied on such transactions.

(b) Umbrella Organisation for Retail Payment Systems: Progress

104. The Vision Document for Payment and Settlement Systems, 2005-2008 envisages establishment of an institutional structure owned by banks and other financial institutions for retail payment systems. The objective of setting up of such an organisation is to optimise the use of resources through consolidation of the existing infrastructure and by building up of new infrastructure. The IBA constituted a Working Group with 12 banks as its members to study the proposal. The Working Group has recommended setting up of a company under Section 25 of the Companies Act, 1956 which would be owned and operated by banks. The recommendations are under consideration of the IBA and the new organisation is likely to get operational with effect from April 1, 2006.

(c) Business Continuity Plan: Contingency Plan

105. In the recent past, usage of information technology (IT) has increased significantly. With increasing migration to centralised systems, provision for effective back-up and business continuity plans assumes importance. In this context, the Reserve Bank has drawn up a disaster recovery plan for all critical applications including RTGS, the performance of which is tested at quarterly intervals.

106. Furthermore, there is a need for banks to ensure that their plans for business continuity are adequate and comprehensive which could resume business functionalities quickly in a situation of disaster to transact normal business. Banks are, therefore, urged to test their business continuity plans periodically and ensure continuous service.

Information Technology

Financial Sector Technology Vision Document

107. As indicated in the annual policy Statement of April 2005, the Financial Sector Technology Vision Document was placed on the Reserve Bank's website in July 2005. The Vision Document has enumerated the initiatives to be undertaken by the Reserve Bank in the medium-term in order to ensure maintenance of overall systemic efficiency of the financial sector. In this context,

the Document has identified four key areas for information technology (IT) development: regulation and supervision, role of the Institute for Development and Research in Banking Technology (IDRBT) to augment technology absorption, the financial sector and government related functions. Banks are required to ensure that the policy perspectives of the Reserve Bank integrate seamlessly with the approaches followed by them with appropriate focus on corporate governance.

Urban Co-operative Banks

(a) Vision Document for UCBs: Medium-term Framework

108. A medium-term framework for urban co-operative banks (UCBs) is being developed on the basis of feedback received on the draft 'Vision Document for Urban Co-operative Banks'. As the UCBs are subject to dual control by the Reserve Bank and State Governments, the Vision Document envisaged harmonisation of their approaches for facilitating the development of the sector. Accordingly, the Reserve Bank has signed a Memorandum of Understanding (MoU) with three State Governments, *viz*., Andhra Pradesh, Gujarat and Karnataka, and is in the process of entering into MoUs with other States having sizeable presence of UCBs. The MoU envisages drawing up of an action plan through State level Task Forces on UCBs for revival of weak UCBs. It provides for a structured arrangement for coordination and consultation as well as professionalisation of management of UCBs. The draft Vision Document also envisages that facilities and opportunities available to commercial banks should, as far as possible, also be made available to UCBs other than unit and single district banks with deposits less than Rs.100 crore. Accordingly, it is proposed:

- to extend currency chest facility and issuance of licence to conduct foreign exchange business (authorised person licence) to scheduled UCBs registered under the Multi-State Co-operative Societies Act and under the State Acts where the State governments concerned have assured regulatory coordination by entering into MoU with the Reserve Bank. The eligibility norms for these facilities would be notified separately.

(b) Merger/Amalgamation of UCBs

109. Guidelines on merger/amalgamation in the UCB sector were issued by the Reserve Bank with a view to facilitating emergence of strong entities and for providing an avenue for non-disruptive exit of unviable entities. The major focus of the guidelines is on the financial aspects of the merger/amalgamation proposals with a view to protecting depositors' interests and avoiding systemic problems. So far, the Reserve Bank has conveyed 'no objection' to five merger proposals out of which two proposals have already materialised. In order to further smoothen the process of merger in the UCB sector, it is proposed:

- to permit the acquirer UCB to amortise the losses taken over from the acquired UCB over a period of not more than five years, including the year of merger.

(c) 90 Days Norm for UCBs: Relaxation

110. The Reserve Bank has relaxed the 90 days delinquency norm for certain categories of UCBs on requests received from the UCB sector regarding difficulty in meeting the norm. Accordingly, unit banks (*i.e.,* having a single branch/head office) as well as banks having multiple branches within a single district with deposits up to Rs.100 crore would classify their loan accounts as NPAs based on the 180 days delinquency norm instead of the extant 90 days norm. The relaxation would be valid up to end-March 2007 to enable the UCBs concerned to build up adequate provisions and strengthen their procedures in order to transit to the 90 days delinquency norm within the stipulated period.

(d) Restructuring of Weak Scheduled UCBs

111. The Reserve Bank has begun a consultative process for revitalisation and rehabilitation of weak scheduled UCBs. In this context, 10 weak scheduled UCBs are in the process of restructuring and the Reserve Bank is closely monitoring their progress.

The Right to Information Act, 2005

112. The Government has enacted the Right to Information Act, 2005 on June 15, 2005. Pursuant to its enactment, the Reserve Bank has designated the Chief General Manager-in-Charge of the Department of Administration and Personnel Management as the Chief Public Information Officer. Details of the scheme

regarding implementation of the provisions of the Act have been placed on the Reserve Bank's website.

Computation of Exchange Rate Indices - New Series

113. As part of its policy of communication and to aid researchers and analysts, the Reserve Bank has recently updated its 5-country and 36-country indices of nominal effective exchange rates (NEER) and real effective exchange rates (REER). The 5-country indices have been replaced by new 6-currency indices of REER and NEER. The new indices would include two new currencies, both Asian - the Chinese Renminbi and the Hong Kong Dollar. Two currencies in the existing 5-country series, *viz.*, French Franc and Deutsche Mark would be replaced by the Euro. The new indices use 3-year moving average trade weights in place of the fixed trade weights in the 5-country indices. The new series would be published in the December 2005 issue of the Reserve Bank of India Bulletin along with information on methodological and computational details. Simultaneously, the broader 36-country indices of NEER and REER with 1985 as the base year will be updated to 1993-94 as the base year and revisions would be carried out in the weighting pattern. These revised computations are aimed to reflect the changing profile of India's foreign trade.

Mumbai
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